22459

CIA/ER/76-10705 M

Nov 76

CONFIDENTIAL

MICRO ONLY

III. B. Soviet and East European Economic Relations with the US and the West

1. Evolution and Prospects

The driving force behind the growth in trade with the West has been the need of the USSR and Eastern Europe to acquire advanced Western technology and equipment in order to spur domestic economic development. The East also has looked to Western countries for the agricultural products, intermediate goods, and most recently crude oil which cannot be procured elsewhere.

MICROFILMED

In the past decade trade with the West has been the fastest growing sector in the Soviet and East European economies. Exports to the West from these countries rose by an average annual rate of 11% in 1966-70 and by an average of 23% in 1971-75. The willingness of the West to provide an ever increasing amount of credit has allowed for an even more impressive annual rate of import growth, 13% in 1966-70 and 32% in 1971-75.

The constant dollar growth of East-West trade has also been impressive, particularly when contrasted with the real growth in Soviet and East European GNP in 1971-1975. During this period, the GNP of the USSR grew at an average annual rate of 3.9%, exports to the West by an average of 10%, and imports from the West by an estimated 28% annual rate.

41

CONFIDENTIAL

MICRO ONLY.

Growth in East-West Trade

(Billion US $)

	1965		1970		1975	
	Exports to Developed West	Imports from Developed West	Exports to Developed West	Imports from Developed West	Exports to Developed West	Imports from Developed West
Total of Which USSR	1.4	1.6	2.3	2.8	8.0	31.3
Eastern Europe	2.4	2.6	4.1	4.8	10.5	17.1
Poland	0.6	0.5	1.0	0.9	3.1	6.1
Bulgaria	0.2	0.2	0.2	0.3	0.4	1.1
Czechoslovakia	0.4	0.5	0.7	0.9	1.6	2.2
East Germany	0.6	0.6	1.1	1.4	2.6	3.7
Hungary	0.3	0.4	0.6	0.6	1.1	1.8
Romania	0.3	0.3	0.6	0.8	1.7	2.2

Data may not add to totals shown because of rounding.

The East European experience was similar. Aggregate GNP grew at a 5.9% average annual rate in 1971-1975 while exports to the West grew by an estimated 10% and imports by 17% annually.

Soviet and East European trade with the West has expanded in complexity as well as in volume. The USSR and East European countries have sought trade, scientific and technical cooperation, and credit agreements with Western governments in order to enhance their ability to increase trade. Moreover, with the growth of exports and the need to stimulate export growth even further, these nations have become more active in concluding marketing agreements with Western firms or in establishing their own marketing operations in the West. Concomitantly they have placed increased pressure on Western governments to eliminate Western quota restrictions and to obtain most-favored-nation (MFN) status.

The East has also attempted to establish more complex trading relationships with Western companies to insure their ability to obtain both imports of advanced technology and guaranteed markets for their exports. To this end increased stress has been placed on compensation agreements,* and co-production agreements.**

Interest on the part of the USSR and Eastern Europe in expanding East-West trade is stronger than ever; past infusions of Western technology and equipment have only whetted their appetities. For the East Europeans, moreover, cutbacks in the growth of Soviet deliveries are forcing them to increase imports of oil, grain, and industrial materials from the West. During the next decade the East can be expected to intensify its efforts to secure additional Western financing as well as viable export markets in the West.

* Compensation agreements provide for Eastern imports of Western capital goods often on credit which are repaid usually by goods produced by the imported equipment.
** Co-production agreements involve production of components by both East and West, with assembly or further processing occurring in the Eastern country.

An increase in trade with the West has its drawbacks, however. The Soviet and East European economies do not easily cope with the vagaries associated with trade with the West.. The recent Western recession highlighted their vulnerabilities and no doubt raised questions among the leadership of the Communist countries about how to cope with Western business cycles. Nonetheless, the trend points to increased economic interdependence with the West.

The USSR and Eastern Europe will attempt to get the best of both worlds -- increasing the real value of imports from the West while trying to insulate their export industries from Western market disruptions. To this end, these countries are attempting to secure export markets via the use of compensation agreements and -- in the case of Eastern Europe -- co-production agreements and Western equity participation.

The actual growth in East-West trade will be limited by Soviet and East European export capabilities which will constrain the growth in Western imports. Heavier debt service and increased Western concern over rising debt will limit Soviet and East European ability to continue to run huge trade deficits. Unless the large current debt overhang is substantially reduced, import growth in the next decade is likely to be below the rate recorded over the past decade.

Role of the US

The US economy is a major potential source for the advanced technology, agricultural products, and financing desired by the East as well as a potential major market for Soviet and East European exports. The US, however, has played a minor but increasing role in East-West trade. Trade until recently was mainly limited to US exports of agricultural commodities and selected types of equipment which could not be obtained elsewhere, in exchange for petroleum products, hams and metals. In 1970 trade between Communist Europe and the US represented 4% of total East-West trade. This share rose to 8% in 1975 and will be higher in 1976.

Mutual awareness regarding trade possibilities grew with the US-Soviet detente. Since that time Soviet and East European orders for US equipment have increased markedly. Their exports to the US have also risen although significantly slower than imports. Inter-governmental agreements, including the awarding of Eximbank, MFN, and CCC privileges to some East European countries, have played a supportive role in the expansion of this trade. Given a good trading environment, Soviet and East European trade with the US would probably increase as a share of total East-West trade over the next decade. Until credit facilities and other benefits now accorded to Poland and Romania are provided to the other East European countries and the USSR, however, there is a greater likelihood that the US role in East-West trade will decline.

USSR

Although Moscow was previously able to rely heavily on a rapid growth in the labor force and the stock of plant and equipment to spur economic growth, Soviet leaders recognize that further rapid growth can only be achieved by accelerating technological progress. The problem is that the Soviet R&D sector has lagged in developing and applying new technology. The USSR has been forced to turn increasingly to imported technology, via the purchase of machinery and equipment, as a means of accelerating technological progress and economic growth.. The need for an expansion of trade with the West has received priority attention at the last two Party Congresses and the value of Soviet two-way trade with the West has, in fact, grown 6-fold over the past decade to $21.3 billion in 1975.

Although the volume of Soviet imports of machinery from the West comprised only 5% of total domestic investment in machinery in 1975 imported equipment is crucial to the development of key Soviet industries including oil and gasfield development, the chemical industry and the automotive industry. In addition Western equipment and capital provides the basis for significant Soviet raw material development programs including coal, timber, and aluminum. The USSR also relies on Western suppliers to redress domestic shortfalls, most notably in the areas of agricultural products and finished steel.

Moscow's intention to continue to expand trade with the West is clear. Over $12 billion in Soviet orders for Western equipment and pipe have been placed in the last 2½ years, and discussions continue on several other major deals. Moscow obviously hopes to elicit Western participation in additional development projects including offshore oil and gas deposits, Siberian natural gas development, and wood and iron ore processing facilities.

Eastern Europe

Increased trade with the West has been even more critical for Eastern Europe, which is more trade dependent and resource poor than the USSR.

Like the Soviets, the East Europeans decided in the 1960s to import sophisticated machinery and equipment from the West to attack problems of slow growth, low labor productivity and decreasing additions to the labor force. By 1975, in real terms, imports of machinery and equipment from the West were 6 times and total imports from the West 4 times the 1965 level; GNP grew by only two-thirds during the same period. Major machinery import categories have been chemical equipment, oil refineries and petrochemical plants, and equipment for the food and light industries.

In contrast to the USSR, however, Eastern Europe has also become more dependent on the West for materials -- not only for high quality industrial materials unavailable elsewhere such as special steels, synthetics, and plastics, but also for grain, oil, and metals formerly supplied by the USSR. Although still providing the lion's share of fuels and metals to Eastern Europe, Soviet supply constraints have resulted in a slowdown in the growth of oil deliveries in the late 1960s and ferrous metals in the early 1970s. Crop disasters in the USSR led to a sharp cutback in grain deliveries from the 1972 harvest and a cancellation of deliveries after the 1975 harvest, forcing the East Europeans to buy additional amounts of grain in the West.

With East European populations more aware of Western living standards, East European leaderships have also been more attentive to consumer interests than the Soviets. After the Polish riots of 1970, several East European regimes boosted imports of consumer goods from the West. Although Romania and Bulgaria refrained from these purchases and the remaining countries have cut them back in time of austerity, consumer goods purchases remain an important, if small, share of total imports from the West.

Trade with the West began to falter in 1974 as soaring world prices, the ECE ban on beef and cattle imports, and the beginning of Western recession took their toll. The East Europeans, however, did not begin to cut back on imports until the spring of 1975 and the deficit hit $6.7 billion, topping the previous record of $5.4 billion incurred in 1974.

Romania, by cutting imports sharply, was the only country able to reduce its deficit in 1975. On the other hand, Poland's imports -- led by machinery and equipment -- rose 16% and its deficit jumped from $2.4 billion to $3.0 billion.

Efforts to hold imports down and some recovery in exports should permit the East Europeans to pare their cumulative deficit to about $5.5 billion in 1976. Bulgaria, Hungary, and Romania are cutting back on imports and should be able to reduce their deficits significantly. Czechoslovakia, East Germany, and Poland -- needing extraordinary imports of grain and fodder -- will have difficulties in trimming their deficits.

Given their already heavy debt burden, the East Europeans will have to continue to curtail import growth over the next few years. The extent will depend on the degree of recovery in their Western export markets, domestic constraints on their ability to export, and the availability of financing. In addition, some of the countries -- especially Bulgaria, Czechoslovakia, East Germany, and Hungary -- may well have to divert some exports to the Soviets in order to make up for the deterioration in their terms of trade.

In addition to strong efforts to push exports to the West, the East Europeans will continue to seek compensation deals and co-production arrangements in an attempt to ease their hard currency payments position. Western reluctance to become involved in such arrangements, however, limits their potential.

As long as Western markets are favorable, most of the East European countries should be able to import most of the agricultural and industrial materials they need. But they can do this only if they are willing to limit their desire for Western equipment and technology. Such imports can be curbed for a while without seriously harming economic growth.

- Facing difficulties in borrowing as well as a restive population and committed to continued rapid economic growth, Poland is particularly in a bind. We project that, given supply constraints, Poland can at best increase its exports to the developed West only 18% a year in 1976-1980 at current prices. This would limit average annual import growth to 5% (no growth in real terms) if Poland is to keep its debt within manageable bounds.
- The Romanians, although also committed to rapid economic growth, are in a somewhat better position because of their willingness to cut imports sharply in 1975-76. But imports will have to pick up substantially soon if the Romanians are to come close to realizing their ambitious growth plans.

- The Bulgarians also are reluctant to slacken their rapid economic growth. They may, however, have to heed the advice of the USSR -- the only country apt to bail them out if necessary. The Soviet Ambassador to Sofia recently stated that Bulgaria ought to scale down its grandiose plans for imports from the West and economic growth.
- East Germany, Czechoslovakia, and Hungary will meet their obligations and keep their deficits under control, but with reduced import growth. This may not be a major problem, however, because the economic growth targets are low.

2. Importance of Economic Interests to Overall Objectives

In the current Soviet (and East European) policy of detente, economic considerations are extremely important, but not overriding. Such problems as coping with China, controlling nuclear risks, and advancing political influence in Western Europe and elsewhere are also important factors. Economic considerations complement these other aspects of detente, offering an alternative to autarky and a response to changing world conditions.

If detente suffered in important strategic or political areas, Moscow would make great efforts to sustain its foreign economic policy so long as some major Western governments were receptive. The economic considerations that led Moscow to formulate its policy of expanding business ties with the West would remain even if certain political considerations supporting detente lost various specific competitions with other Soviet policy priorities.

Almost 60 years of economic experimentation have failed to deliver the USSR from its relative technological backwardness compared with the industrial states of the West; this has been acknowledged by Soviet officials. These Soviets also acknowledge that the gap may widen between East and West in the vital area of economic competition unless vigorous efforts are made to adapt to the demands for technological growth.

Apart from the desire to lessen the risk of global nuclear conflict, probably no other aspect of Moscow's current detente policy has developed a stronger consensus among Soviet leaders than its economic policy. However, there are doubtless greatly differing views on the implications of detente for the structuring of the Soviet domestic economy. The need for Western technology and credits seems to have few serious critics, though there are strong forces in Moscow who oppose any fundamental tampering with the Soviet economy in order that it might more effectively absorb the technology and investments the USSR seeks. There are also influential circles who worry about the constraining implications of growing economic interdependence.

A major setback for detente would seriously hamper but not stop the Soviet leaders from pursuing their foreign economic course. The Kremlin would likely judge that it would have to forego some of the economic benefits it seeks from the West, but that it would be able to maintain economic dealings with some major Western governments and in time restore beneficial relationships with others.

IV.A.3.A. Soviet and East European Debt

The net hard currency debt of the USSR and Eastern Europe has increased from only $13 billion at the end of 1973 to $29 billion at the end of 1975, and it will probably grow to near $40 billion by the end of 1976. These countries had programmed a large increase in imports, financed partly by long-term credits, which were readily available from Western countries. Their debt, therefore, was expected to go up in any event. What pushed up the debt to the current massive proportions was mainly the Western economic recession, which nearly halted the growth of Soviet and East European hard currency exports. Massive Soviet, East German, and Polish grain import requirements as a result of last year's disastrous Soviet harvest added to their hard currency deficit and increased their borrowing needs.

The prospective hard currency deficits for 1976 are likely to raise the USSR's debt to over $13 billion and Eastern Europe's to as much as $25 billion. Although no Soviet or East European borrower has been turned down, the cost of Western credit and the difficulty of obtaining it are increasing. Many Western bankers have reached legal or self-imposed ceilings on Soviet and East European debt. In addition, the international banking community is becoming increasingly concerned about the debt problem and the persistence of hard currency deficits. Western bankers have

Table 1

USSR and Eastern Europe: Total Hard Currency Debt

	1974		1975		1976[1]
	Debt at Yearend[2] (Billion US $)	Debt Service Ratio[3] (Percent)	Debt at Yearend[2] (Billion US $)	Debt Service Ratio[3] (Percent)	Debt at Yearend[2] (Billion US $)
USSR	5.0	17	10.0	22	13.0
Eastern Europe	13.2	....	19.0	....	24.9
Bulgaria	1.2	38	1.8	65	2.3
Czechoslovakia	1.1	17	1.5	22	2.1
East Germany	2.8	17	3.8	22	4.7
Hungary	1.5	19	2.1	31	2.6
Poland	3.9	27	6.9	43	10.0
Romania	2.6	29	3.0	45	3.2

1. Projected.
2. Estimated.
3. Repayments of principal and interest as a percentage of merchandise exports. Total hard currency exports are used in the Soviet case; exports to the developed West for the East European countries.

long viewed the USSR and East European countries as excellent credit risks. The absence of defaults and the minimal amount of refinancing during the entire postwar period for these countries indeed compares very favorably with the experience of many non-Communist governments and firms. Even today, the Communist countries have higher credit ratings than almost any LDC.

The high credit ratings of the USSR and Eastern Europe are also based on the assumption of a high degree of political stability. It has been assumed that Communist governments were strong enough to make the economic adjustments necessary to cope with any debt problem, including sharp cuts in imports. For most East European countries, it has also been assumed that Moscow was the banker of last resort, as has sometimes been the case in the past, particularly for Bulgaria. The assumption of political stability has been somewhat undermined by the cave-in of the Polish government in the face of worker demonstrations after the recent attempt to increase food prices. Similarly, various reports indicated that Moscow was generally giving a lower priority to supporting its East European allies' debt. Gierek's recent success in obtaining above-plan Soviet deliveries of oil and the resumption of Soviet grain deliveries from the bumper harvest may indicate a softening -- but not an abandoning -- of the tightfisted Soviet position.

Western bankers' concern about the Soviet and East European debt problem could snowball, but this does not seem likely. The USSR is still viewed as a good credit risk, and most Western governments are continuing to guarantee long-term credits, although with closer examination than in the past. Poland's credit status is most at risk. West European governments believe they have a political stake in expanded trade with the East and are willing to provide large credits to sustain its growth. Nevertheless, should Soviet and East European hard currency deficits long continue at recent high levels, these countries would encounter rapidly increasing difficulty in obtaining new credits.

USSR

The rapid growth in imports of Western equipment and pipe under credit and the unexpectedly large trade deficits in 1975-1976 have led to a substantial rise in the USSR's hard currency debt; total net debt rose from roughly $5 billion in 1974 to over $10 billion by the end of last year; by the end of 1976 net Soviet indebtedness should exceed $13 billion. Roughly three-quarters of this debt is medium- and long-term, largely held or guaranteed by Western governments. Net Soviet liabilities on the Eurocurrency market, representing non-guaranteed indebtedness and mostly short-term in composition, rose from less than $100 million at the end of 1974 to $6.4 billion by the end of the first half 1976.

Table

USSR: Hard Currency Balance of Payments and Outstanding Indebtedness

				Million US $
	1974	1975	1976[1]	1977[2]
Merchandise exports, f.o.b.[3]	7,630	7,800	10,300	13,000
Merchandise imports, f.o.b.[3]	8,541	14,100	15,300	16,000
Merchandise trade, net. N.E.S.[4]	400	200	400	400
Non-monetary gold	800	1,000	1,000	1,300
Services and transfer payments, net	300	+100	-300	-300
CURRENT ACCOUNT BALANCE	589	-5,000	-3,900	-1,600
Medium- and long-term capital, net[5]	820	3,000	2,200	1,317
BASIC BALANCE	1,409	-2,000	-1,700	-300
Yearend net indebtedness	5,000	10,000	13,000	15,000-16,000

1. Preliminary.
2. Estimated.
3. Official Soviet foreign trade statistics.
4. Including estimated revenues from arms sales and hard currency expenditures for Cuban sugar. It excludes hard currency trade with other CEMA countries.
5. Including medium- and long-term syndicated Eurocurrency credits which were used, in part, for compensatory financing.

The USSR seems reasonably assured of obtaining most of the medium- and long-term credits it will require to finance future capital goods imports from the West. The governments of France, West Germany, Japan, the UK, Canada, and (domestic conditions permitting) Italy either have advanced or guaranteed large credit lines or can be expected to do so in the future on the basis of new Soviet orders. Although some Western governments are looking more closely at the rapid growth in Soviet indebtedness, they remain basically optimistic concerning Soviet creditworthiness.

In contrast, Moscow's ability to obtain the non-guaranteed credits it needs appears constrained. The USSR was forced to borrow roughly $6 billion from Western commercial bankers over the past 24 months and as a result many major Western banks are currently near or at their lending limits vis-a-vis the USSR. These banks in particular, and the Western banking community in general have become far more selective with regard to additional lending. The USSR is finding it more difficult to obtain short-term credits and probably will be forced to pay higher interest rates and front-end fees to obtain Western participation in medium-term syndications. Most bankers seem to prefer supplier's credits which yield a profitable return and enhance the lending bank's relationship with the Western exporter.

For its part, the USSR has apparently realized that its heavy borrowing in 1975 has limited its ability to heavily tap the Euromarket for funds this year. Moreover, Soviet borrowers remain extremely sensitive to the nominal interest rates they must pay and view any rate increase -- which would probably occur if Moscow were to seek new syndications -- as adversely affecting their credit standing in the West. To protect its credit rating as well as its remaining borrowing capacity, Moscow has taken several steps to reduce its dependency on the Eurocurrency market for financial credits. These steps have included:

- a tightening of controls over foreign exchange expenditures, including deferment of cash down payments on some orders until 1977 and the delay until next year of cash payments for some goods already delivered.
- a greater use of promissory note financing for equipment imports which Moscow would normally have concluded on a cash basis. European sources report a steady supply of five-year fixed rate (7.5%) Soviet promissory notes being discounted on the non-recourse market, and a large percentage of equipment orders in the US are also apparently being financed by this method.
- a channelling of orders on several major deals to [redacted] firms to take advantage of long-term credits which have been extended but heretofore have been largely unused. In many cases, this trade diversion has been at the expense of competing US companies.
- heavy sales of gold in the West despite poor market conditions; $635 million was earned from gold sales in Switzerland during the first nine months of this year and the Soviets reportedly have been heavy sellers in recent weeks. The recent rise in the gold price has made this an increasingly attractive alternative.

Although remaining a heavy borrower on Western money markets, the USSR has been able to substantially reduce its reliance on private credits in financing this year's hard currency trade deficit. While the $3.4 billion hard currency trade deficit incurred in the first half of 1976 equalled the deficit recorded in January-June of last year, net Soviet borrowings on Western private money markets in these respective periods fell from $2.9 billion to $1.6 billion.

The USSR almost certainly would have preferred to refrain completely from seeking a Eurocurrency syndication in 1976; there is some indication that its decision to do so last April was unexpected. Market response to this syndication ($250 million at 1.25% over the London Interbank Offered Rate) was very poor as evidenced by the 17% participation by Communist-owned banks in the West. Since it is highly unlikely that Moscow will accept the higher interest rate spreads Western bankers will insist upon on any future syndications, it is doubtful that the USSR will enter the Eurocurrency market for a second syndication this year.

As long as Soviet Eurocurrency indebtedness remains at or above present levels the USSR will probably attempt to limit trade deficits, and thus import growth from the West, to levels which can be financed without resorting to general purpose borrowing. In order to maximize the growth of imports from the West Moscow can be expected to make heavy use of government-backed credits. Along with anticipated revenues from gold and arms sales, transportation earnings, and tourist receipts, such tied borrowing should allow the USSR to finance annual trade deficits on the order of $2.5 billion to $3 billion for the next few years.

Should the USSR again incur unexpectedly large trade deficits, it will probably have to place greater emphasis on expanding exports and/or cutting back on non-grain imports. Unlike 1973 or 1975-1976 the USSR is not expected to be able to rely heavily on general purpose borrowing to make up a major portion of the shortfall. In addition to taking the above mentioned steps, high level Soviet officials have stated that hard currency needs have caused the USSR to increase the emphasis placed on expanding raw material exports in an effort to rapidly boost hard currency receipts.

Poland

Gierek -- in a reversal of Gomulka's more cautious approach -- has taken maximum advantage of Western credits to import vast amounts of capital equipment to modernize the Polish economy. The very rapid expansion of Poland's imports from the West in the 1970s -- Warsaw's trade moved into deficit beginning in 1972 -- reflects the national objective of the Gierek regime to "catch up," not just with the West but also with other East European countries. A second related motive, no less urgent, was to raise the standard of living for urban workers.

The Western recession added greatly to Poland's borrowing needs; trade deficits climbed to $2.4 billion in 1974 and $3.0 billion in 1975. By the end of 1975, the hard currency debt had hit $6.9 billion. Although still relying heavily on government guaranteed credits -- which accounted for roughly one-third of the total debt at end 1975 -- Poland has been forced since 1972 to greatly boost its Eurocurrency borrowing to obtain the financial credits needed to help cover the unexpectedly large deficits and meet rising repayment obligations. By yearend 1975 known net Eurocurrency liabilities had hit $3.4 billion. As a result of heavy short-term borrowing on the Euromarket, Poland's debt structure -- once the best in Eastern Europe -- deteriorated. Long-term debt dropped from about two-thirds of the total in 1970 to roughly one-third 1975.

In spite of Polish efforts to cut back on import growth and some recovery in exports, this year's trade deficit will be about the same as in 1975. This will be offset only slightly by an expected surplus on other current account items -- reflecting the beginning of special pension payments from West Germany -- and the debt could approach $10 billion by the end of the year.

Table

Poland: Hard Currency Balance of Payments and Outstanding Indebtedness

Million US $

	1974	1975	1976[1]	1977[1]
Merchandise exports, f.o.b.[2]	3,100	3,000	3,360	4,030
Merchandise imports, f.o.b.[2]	5,340	6,220	6,610	7,270
Service and private transfers, net	67	-40	200[3]	100
CURRENT ACCOUNT BALANCE	-2,173	-3,260	3,050	-3,140
Medium- and long-term capital, net[4]	1,073	1,745	2,000	2,000
BASIC BALANCE	-1,100	-1,515	-1,050	-1,140
Yearend net indebtedness	3,950	6,870	10,000	13,000

1. Estimated.
2. For balance of payments purposes, official Polish data on exports and imports were adjusted to correct for errors in the treatment of transport.
3. Reflecting the beginning of special payments from West Germany.
4. Some of which was used for compensatory financing.

Because of the heavy build up of its debt and rising debt service, Poland is finding it increasingly difficult to arrange for Western financial credits. In first half 1976, known net Eurocurrency liabilities rose by only $569 million, down substantially from $954 million in first half 1975. Indicative of the seriousness of both Poland's payments crunch and its inability to secure sufficient financial credits are: the [redacted] request to the French that repayments on existing government-backed loans be extended by 10 years; and the unsuccessful recent request to Belgium that the balance of a 1973 export credit line be handed over for Poland's immediate use. Poland is also finding it necessary to pay higher interest rates on those loans it is able to obtain.

Poland is in the most serious predicament among the CEMA countries and will have serious balance of payments problems for the next several years. Reduced Western confidence in Poland's ability to manage its debt will probably make it impossible for Warsaw to continue to borrow heavily in Western money markets. Poland, however, is not totally without resources. There are sizable government-guaranteed credits at Poland's disposal and special West German payments will help through 1978. These funds are woefully inadequate, however, to finance the import growth Warsaw considers necessary.

The crucial problem facing the leadership is how to obtain the imports of industrial inputs and of grain and feedstuffs necessary to meet economic growth plans and to permit some rise in personal consumption. Strong popular reaction to austerity measures forced the government to back down on two previous occasions (December 1970 and June 1976), and the fear of provoking new disturbances will be an important constraint on Warsaw's freedom of action. Warsaw has already turned to Moscow for help. The USSR has recently agreed to above-plan deliveries of oil and may do the same for grain.

If Poland is unable to cut back on imports sufficiently to manage its debt, there is a good chance that at some point in the next few years it will seek to refinance or reschedule its Western debt on a selective basis. The [redacted] approach to the French may have been the first step in this direction. One of the factors affecting refinancing will be whether a long-term loan by a consortium of Western bankers -- backed by their governments -- is feasible. West Germany, Poland's major creditor, may be tired of being out front in helping Poland with credits and other payments and would want to bring in other governments, possibly including the United States. A much larger loan than the recent $425 million West German financial credit may be necessary, however, to bail out Poland.

Romania

Romania has incurred a large hard currency debt as a result of its long standing policy of importing substantial amounts of Western technology and equipment. After permitting its hard currency debt to escalate to disturbing proportions in the 1960s, Bucharest reacted in the early 1970s by cutting back on the growth of new borrowing and by greatly spreading the debt out.

Romanian ability to manage its debt began to go awry in 1974, however, largely as a result of lower Western demand

and the EC ban on beef. Moreover, in 1975, exports plunged mainly because of shortfalls in agricultural production. Even though Bucharest reacted by cutting back on imports, Romania incurred a $0.5 billion trade deficit for the second year in a row. The hard currency debt rose to $3.0 billion by end 1975.

Credits backed by Western governments represent the single largest source of financing and by 1975 accounted for more than one-fourth of Romania's total debt. Romania has also received financing from Iran and the IMF. Bucharest's known borrowing on Eurocurrency markets has remained small with net liabilities totalling only $506 million by yearend 1975.

This year the Romanians are taking stringent measures to bring their trade deficit into line. The expected sharp cut in imports, together with gains in exports, should bring trade nearly into balance. But because the deficit on invisibles is expected to rise due to growing interest payments, Romania could end up the year with an even higher debt than last year.

Because Bucharest does not readily postpone investment or cut back production plans, Romania is expected to allow a rapid rise in imports after 1976. Although prospects for exports are good given the rise in economic activity in the West, Romania may well run large deficits for the next several years. Despite its small exposure on Euromarkets, Romania's heavy debt burden will make it difficult to obtain financial credits to help cover the deficits. Bucharest's credit rating has also suffered from the fact that it has twice sought refinancing from West Germany -- in 1970 and 1975 -- and that on the second occasion refinancing was refused.

On the plus side, Romania has been granted large long-term development credits by the World Bank. Ceausescu also has cultivated a close relationship with Iran, which already has granted sizable credits. In addition, Romania could draw on an estimated $250 million in gold reserves. On balance, however, there is a high probability that Romania will once again be seeking refinancing in the next few years.

East Germany

In recent years, East Germany's appetite for Western goods has far exceeded its ability to pay. A continued slow-down in the growth of Soviet deliveries has increased dependence on the West for industrial materials and grain. This in turn has led the leadership to seek, as a matter of urgency, the technology needed to compete in Western markets.

The heavy borrowing required to cover the large trade deficits incurred in recent years pushed East Germany's hard currency indebtedness up to $3.8 billion at yearend 1975. Net liabilities on the Eurocurrency market accounted for nearly one-half of the total debt, and indebtedness on government-guaranteed and other supplier credits, mostly from West Germany, accounted for perhaps another two-fifths.

The East Germans were unable to reduce substantially their trade deficit in the first half of 1976, compared with first half 1975, and because of the need for extraordinary amounts of grain are not expected to do better for the balance of the year. Thus, the debt could rise to $4.7 billion by yearend. The East Germans apparently are again heavily into the Eurocurrency market having borrowed $500 million in the first half of the year. They are now seeking another $400 million to finance the large imports of grain and fodder.

The East German debt burden is likely to rise significantly in the next few years, though not to the danger point. The trade deficit may drop in 1977, but after that is expected to rise gradually as East Germany permits some pick-up in imports. The East Germans, however, probably will try to hold average annual deficits below the 1975 level even if large grain import requirements force further cutbacks in other areas. Even so, East Germany will have to resort to large-scale borrowing in the West. This poses no immediate problem; although the cost of borrowing is expected to go up; banks are still ready to lend to the East Germans.

Bulgaria

After indulging in a spending spree in the West in the mid-60s, Bulgaria was forced to sharply curb the growth of its indebtedness. Sofia, however, suffered a setback in 1974-75 due to Western inflation, a new spurt in imports of semi-manufactures, and stagnating exports. The heavy borrowing -- mostly in financial credits -- required to cover the resulting trade deficits boosted Bulgaria's net hard currency indebtedness to $1.8 billion by yearend 1975. By cutting back sharply on its imports this year, Bulgaria should be able to significantly reduce its trade deficit and its need for new credits. Borrowing on the Euromarket rose by only $200 million in first half 1976 as compared with $300 million in first half 1975. By yearend Bulgaria's debt could hit $2.3 billion.

The Bulgarians are under great pressure to bring their debt burden down to a manageable level. Unless Sofia can greatly stretch out its debt -- only about one-third is in long-term -- it may well have to accept absolute drops in its imports for several years and thus a cutback in economic growth. The Soviets, who have bailed the Bulgarians out before, if necessary will come to their aid again.

Hungary

Although habitually conservative and pragmatic in its financial relations with the West, Hungary had to borrow heavily in 1974-75 to cover unexpectedly large trade deficits resulting from the weakening of Western demand, the EC ban on beef and cattle, and severely deteriorating terms of trade. Even though Hungary took strong measures to curb imports in the second half of 1975, the trade deficit hit a record $700 million. Hungary's net hard currency indebtedness rose from $600 million at yearend 1970 to only $900 million at yearend 1973, only to soar to $2.1 billion by yearend 1975. Since the late 1960s the bulk of Hungary's liabilities has been in commercial bank loans, which now account for more than 80% of the total debt, the highest share in Eastern Europe.

The stringent measures taken this year to cut imports, together with the good recovery in exports, should bring the trade deficit down to $500 million. But, in the first half of the year at least, net liabilities on the Euromarket rose by $400 million, the same as in first half 1975. The Hungarians, however, apparently do not expect to borrow heavily in the second half of the year, and the debt should not rise to more than $2.6 billion by yearend.

Hungary's debt is expected to rise relatively slowly over the next few years. Because of its decisive action in cutting imports, Budapest is in a good position -- if exports continue to recover -- to allow some increase in imports after 1976. Bankers apparently consider Hungary a good credit risk and will continue to provide the funds needed.

Czechoslovakia

The Czechoslovaks have, if anything, been more conservative than the Hungarians in their Western borrowing and most likely will continue to be so. Although its debt has risen rapidly since 1970 and it encountered problems in its export markets in 1974-75, Czechoslovakia still has one of the lowest debt service ratios in Eastern Europe. Czechoslovakia, however, is the only East European country that appears to be having difficulties in realizing any gains in its exports this year. Imports are being held down, but not as much as exports. Thus, Czechoslovakia is expected to incur a deficit about the same as the $600 million recorded in 1975. However, its debt -- although expected to rise from $1.5 billion at yearend 1975 to $2.1 billion at yearend 1976 -- should present no problem.

Czechoslovakia has not made much of the Eurocurrency market in the past. Its net liabilities rose only $200 million in the first half of the year, but Prague apparently is now stepping up its Euromarket borrowing: it recently received a $200 million loan from a consortium of four West German banks. Because of its low debt, Prague probably will be able to raise considerably more from commercial banks.

IV. B. Constraints Facing the USSR and Eastern Europe

1. Internal and Structural

One of the major constraints in the growth of trade with the West is Soviet and East European inability to rapidly expand exports. These countries have failed to improve the quality and sophistication of their machinery and equipment and are forced to rely upon exports of raw materials, semi-manufactures, and -- for some East European countries -- finished consumer goods.

The Soviet-style economic system of planned material balances is singularly ill-equipped to compete in Western markets. Soviet and East European producers have long operated in a seller's market whereby the allocation of all production is guaranteed in advance by the "plan." Quantity thus takes precedence over quality, little attention is given to providing spare parts over servicing, and there is little reward for innovation. Most producers attempt to avoid having to produce for the Western market; they have little direct knowledge of Western market conditions and receive insufficient reward for the added care they are expected to take in export production.

These problems are paramount in the area of finished goods. Soviet and most East European leaders have been loath to make the changes required for a meaningful expansion in exports of manufactured products to the West. To date most of the implemented programs to diversify exports have been peripheral to the real problems of providing export producers with proper incentives, direct access to Western consumers, and the flexibility to rapidly respond to Western market requirements. Hungary, which relies heavily on manufactured goods exports, has recently begun to implement meaningful changes. Among the inducements to Hungarian enterprises are easier access to Western credits, preferential interest rates, and reimbursement for changes in production lines required to upgrade the quality of export products. It will take some time, however, before these changes can be translated into rapid export growth. Other East European countries such as Czechoslovakia and East Germany which also rely heavily on exports of finished manufactured products remain reluctant to alter the traditional system. The Soviets, in particular, have done little to spur manufactured goods exports despite leader-ship exhortations to the contrary.

Romania, Poland, and the USSR rely heavily on raw materials and semi-manufactures in their exports to the West and hence have been under less pressure to tamper with their traditional economic system. Supply constraints, however, hinder the ability of these countries to rapidly expand exports. With rapidly dwindling reserves, Romania must now rely on Western crude oil to continue petroleum products exports. The slow growth of Polish coal production, combined with increasing domestic needs, will make it similarly difficult for Warsaw to boost coal exports to the West.

All the East European countries are further constrained in their ability to increase exports by their need to satisfy consumer demands. Although some of the countries have warned their people to expect a slowdown in the growth of consumption, the leaders, all too aware of the unrest in Poland, must handle their trade in such a way as to minimize the chances for serious popular discontent. Poland, for example, has already reduced meat exports because of the serious shortages in the domestic market, and coal is now being exported at the expense of the consumer, but Warsaw may have to ultimately give in to the population's grumbling over insufficient coal for home use. Romania -- long relying heavily on exports of meat and grain -- is running into problems in increasing exports because of domestic requirements. The East Europeans may even have to curtail the growth of consumer manufactures exports in order to provide more goods for the population.

With a large resource base and a greater control over its populace, the USSR is perhaps in the best position to expand exports to the West. Nonetheless, they too have had and are expected to continue to have problems in this area. The Soviets rely on raw materials -- oil, natural gas, timber -- and semi-manufactured products such as diamonds and platinum group metals for the major share of hard currency export earnings. Finished manufactured goods exports accounted on the average for less than 5% of exports to the West in 1971-1975.

Soviet ability to expand rates of extraction of raw materials in the near term appear limited. Many of the largest Soviet raw material deposits are located in Siberia and will remain undeveloped until the 1980s. Several years of development and completion of the BAM railroad in the early 1980s would be required before significant export capabilities of many minerals and metals could be reached. During the balance of the decade, the USSR will have to rely on exports of raw materials and semi-manufactures -- oil, wood, diamonds, platinum -- from traditional sources. With the exception of natural gas and possibly timber, their ability to rapidly expand exports from these sources is limited. Any substantial increase in oil exports to the West for example, will probably be at the expense of domestic consumption or exports to East European and less developed country importers.

Over the longer term, Soviet raw material resource development will rest largely on Moscow's ability to obtain Western extraction technology and equipment. To this end the USSR has signed major development agreements with Japan (coal and forestry development), France (development of aluminum processing facilities), West Germany (iron and steel complex) and several countries for chemical plants and natural gas transmission equipment. In all cases, Soviet exports from these projects are assured by compensation agreements, and over time, will provide earnings well in excess of the cost of repaying credits.

VII. A. Costs and Benefits of Soviet and East European Assistance in Development in the Third World

The USSR and Eastern Europe extended $17.5 billion in economic assistance to the Third World in the period 1954-1975. Of this total roughly $7.6 billion was drawn down: $5.9 billion from the USSR and $1.7 billion from Eastern Europe.

Soviet and East European economic assistance has been provided at relatively little cost. Although aid requirements levied against domestic output of the Communist countries may cause occasional problems in certain sectors, aid deliveries are trivial when measured against GNP. Thus annual Soviet outlays for aid have averaged less than a half billion dollars annually in 1971-75, accounting for roughly 0.05% of GNP. East European deliveries of about $150 million yearly over the same period represented about the same percentage of East European GNP.

By the end of 1975 more than a third of the $7.6 billion of Soviet-East European aid provided LDCs in the past 22 years had already been repaid, and net annual aid transfers were running well below $200 million. In the next few years we expect the flow to reverse itself in the Communist favor, as relatively constant aid flows fall below principal and interest payments that are moving sharply higher.

Repayments usually are in commodities, or the products of Communist built plants that normally impose a smaller burden on LDCs than cash payments. In some cases repayments in commodities are also advantageous to the donors as they guarantee a flow of raw materials vital to Communist needs. For example, commodity repayments are providing:

- All of the USSR's natural gas imports (from Iran and Afghanistan);
- Approximately 5 million tons of crude oil from Iraq annually;
- More than half the USSR's bauxite imports (from Guinea); and,
- All Soviet raw cotton imports (largely from Egypt).

Closer economic ties with the Third World -- an important underpinning of Moscow's foreign policy -- often has been established and consolidated through the aid program. The growth of Communist-Third World trade relations, for example, is one of the most important corollaries of the economic assistance program. Soviet aid was at first directly responsible for the sharp rise in trade with the Third World and is now indirectly responsible for its continued growth. The USSR has found aid recipients to be important capital goods markets and supplementary suppliers of raw materials and consumer goods.

Because the aid program is highly visible and heavily concentrated in a few countries, Communist aid often has gained a competitive edge over Western programs despite its less than 2% contribution to global net aid flows. For a number of countries (especially Egypt, Afghanistan, and India in some years) Communist countries have provided the bulk of their economic assistance. Moscow also has scored politically in some countries despite relatively small outlays. Its help to the development of public sector industrial complexes, which Western countries would not support, was accompanied by propaganda that often was convincing. In some cases the aid has contributed significantly to LDC growth potential. In Egypt and India, for example, the USSR contributed importantly to publicly-owned heavy industrial plant capacity; in Syria and Iraq, Moscow was responsible for developing national oil industries. In several instances Moscow gained extra prestige with aid offers from major installations turned down by other donors e.g., the Aswan Dam, the Bokaro steel mill in India, and the Esfahan steel mill in Iran.

Soviet and East European military sales to LDCs, estimated at less than $9 billion in 1971-1975, also are provided at relatively little cost to Communist countries. Despite Moscow's willingness to supply its most sophisticated weapons systems to LDCs, it often exacts prices that may be nearly comparable to the cost of producing the equipment in the US. Although earlier agreements may have included concessionary pricing and allowed deferred payments, many agreements in the last few years are believed to be cash sales. The change to cash sales basically reflects sales to Arab countries receiving financial support from the oil-rich Arab States and sales to OPEC countries. Moscow thus has developed a new source of hard currency while still concentrating its military program in the strategic Middle Eastern and North African area.